Exhibit No.:	
Issues:	*Tank Painting Expense, Business Transformation*
Witness:	*Kimberly K. Bolin.*
Sponsoring Party:	*MoPSC Staff*
Type of Exhibit:	*Rebuttal Testimony*
Case No.:	*WR-2011-0337*
Date Testimony Prepared:	*January 19, 2012*

MISSOURI PUBLIC SERVICE COMMISSION

REGUALTORY REVIEW DIVISION

UTILITY SERVICES

REBUTTAL TESTIMONY

OF

KIMBERLY K. BOLIN

MISSOURI-AMERICAN WATER COMPANY

CASE NO. WR-2011-0337

Jefferson City, Missouri
January 2012

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OF

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KIMBERLY K. BOLIN

MISSOURI-AMERICAN WATER COMPANY

CASE NO. WR-2011-0337

Q. Please state your name and business address.

A. Kimberly K. Bolin, 200 Madison Street, Suite 440, Jefferson City, MO 65102.

Q. By whom are you employed and in what capacity?

A. I am employed by the Missouri Public Service Commission (Commission) as a Utility Regulatory Auditor V.

Q. Are you the same Kimberly K. Bolin who has filed Direct Testimony in this case?

A. Yes.

Q. What is the purpose of your Rebuttal Testimony?

A. My Rebuttal Testimony will address the Direct Testimony of Missouri-American Water Company (MAWC or Company) witnesses Jeanne M. Tinsley and Greg A. Weeks concerning tank painting expense and the tank painting tracker. I will also address MAWC's request in Company witness Dennis R. William's Direct Testimony for special accounting treatment related to depreciation expense and Allowance for Funds Used During Construction (AFUDC) for the Business Transformation assets.

EXECUTIVE SUMMARY

Q. What topics are addressed in this piece of testimony?

A. I will address Staff's recommendation to discontinue the tank painting tracker, and also discuss the appropriate annual level of tank painting expense to include in MAWC's cost of service. Additionally, I will address the reasons the Commission should not grant the Company's request for special treatment of depreciation expense and allowance for funds used during construction related to the Business Transformation program.

TANK PAINTING EXPENSE AND TRACKER

Q. Does the Staff support the Company's proposal to increase the annual amount of tank painting expense from $1 million to $1.6 million to be included in its cost of service?

A. No. The Staff has recommended an annual tank painting expense (not including the amortization of the tank painting tracker) of $1,370,136. Staff based its recommended level of tank painting expense upon a three-year average of tank painting expenses (calendar years 2008, 2009 and 2010).

Q. Is Staff proposing a continuation of the tank painting expense tracker that was also established in Case No. WR-2007-0216 and continued in the last two rate cases (Case Nos. WR-2008-0311 and WR-2010-0131)?

A. No. Staff asserts that tank painting expense is a planned, on-going maintenance cost that is incurred every year just like any other maintenance costs the Company incurs. While the expense level for tank painting may fluctuate year to year, this type of maintenance activity does not require special ratemaking treatment that would allow the Company a guaranteed dollar for dollar recovery of the expense. Instead, a normalized level of tank painting expense should be established and included in the cost of service.

Q. On page 8 of Mr. Weeks Direct Testimony he states, "...the Tracker facilitates direct auditing of Company financial records to determine its level of expenditures over time on the repainting of its tanks." Does Staff agree with this statement?

A. No. Just like any other maintenance expense, the amount of tank painting expense that is incurred every year can be verified and audited using normal accounting records without a tank painting tracker. The only purpose of the tracker is to provide the Company with an opportunity for dollar for dollar recovery of the expense.

Q. Does the Staff agree that the Company's $1.6 million annual level of tank painting expense is a reasonable amount to be included in the Company cost of service?

A. No. The Company's proposed level of $1.6 million for annual tank painting expense is calculated based upon many estimates, such as the total estimated cost to paint all tank exterior and interior surfaces and the life expectancies per paint coating. Staff recommends that the use of the Company's historical tank painting costs is the best method for establishing a normalized level of tank painting expense. Historical costs are also used to establish normalized levels for other maintenance expenses, as well as other types of expense.

Q. How did the Staff allocate the annualized tank painting expense between the water districts of MAWC?

A. Staff allocated the annualized tank painting expense by the number of tanks in each district. Staff has used this method to allocate the tank painting expense in previous MAWC rate cases.

Q. Is Staff proposing a different method of allocating tank painting expense in this case?

A. Yes, after further review of Staff's calculation and allocations, Staff asserts that tank painting expense should be allocated based upon the amount of total square footage of tanks that require painting.

Q. Why is Staff proposing a different method of allocating tank painting expense in this case?

A. Historically, Staff has allocated tank painting expense based upon the number or tanks in each district. This allocation method is not appropriate to use because the method does not factor in the size of each water tank. It stands to reason that the larger the tank, the more it will cost to paint the tank. Under Staff's initial allocation in this case, based upon the number of tanks, Brunswick is allocated more costs even though in the Brunswick District the Company has five tanks that need to be painted with a combined exterior and interior surfaces approximately 10,058 square feet. In comparison, in the Jefferson City District, there are three water tanks with a combined total of 107,297 square feet that would require painting. In this example, the last known costs for painting all five of the water towers in Brunswick totaled $50,854, while in Jefferson City the last known costs for painting all three water towers totaled $659,400. However, when allocating the tank painting costs based upon the number of tanks, Brunswick is allocated more costs than Jefferson City. Staff's new allocation method provides for a more reasonable distribution of tank painting costs.

<u>BUSINESS TRANSFORMATION</u>

Q. What is the "Business Transformation Program?"

A. American Water Works Company, Inc. (AWW), the parent company of MAWC, is in the process of replacing and upgrading its computer systems for most of its core functional areas such as the computer systems related to human resources, finance and accounting, capital planning, customer and field services, etc. This process began in late 2008 when AWW began conducting a study (Comprehensive Planning Study) into the status of its information technology systems. As a result of the study AWW decided to replace and upgrade computer systems for the various functional areas; this has been termed as the "business transformation program."

Q. In Company witness Williams' Direct Testimony, (page 37, lines 9-11), he states "MAWC requests that the Commission authorize it to delay the onset of depreciating the Business Transformation asset until the effective date of rates that include the depreciation thereon." He also requests that a carrying charge equal to MAWC's allowance for funds used during construction (AFUDC) rate continue to be accrued on Business Transformation assets even after such assets are in-service, until such time as the assets are reflected in MAWC's rate base for ratemaking purposes. Are MAWC's requests similar to that commonly found in an Accounting Authority Order (AAO) request?

A. Yes.

Q. What is an AAO?

A. An AAO is an accounting mechanism that permits deferral of costs from one period to another. The costs deferred are booked as an asset rather than as an expense on the utility's income statement, thus improving the financial picture of the utility in question during the deferral period. During a subsequent rate case, the Commission determines what portion, if any, of the deferred amounts will be recovered in rates. AAOs should be used sparingly because they permit ratemaking consideration of costs from outside the test year. The most common example of AAOs in this jurisdiction are orders from the Commission allowing a company to defer on its books repair and restoration costs associated with "extraordinary events," such as natural disasters or so-called "Acts of God."

For capital related costs, such as those associated with MAWC's Business Transformation assets, AAOs have been used to grant authority to companies to defer depreciation expense and continue to accrue AFUDC on assets even when such assets have been deemed to be in-service.

Q. What happens when an expense is deferred?

A. When an expense is deferred, it is removed from the income statement and entered on the balance sheet, (e.g. Account 186, Miscellaneous Deferred Debits), pending the final disposition of these costs at some future time, usually a rate case.

Q. What is a regulatory asset?

A. A regulatory asset is a cost booked by a utility as an asset on its balance sheet based upon a reasonable likelihood that regulatory authorities will agree to allow rate recovery of the cost at a later time.

Q. What expenses is MAWC asking to be deferred?

A. MAWC is requesting that depreciation expense computed on Business Transformation assets be deferred until the effective date of the next rate case.

Q. What standard has the Commission used to determine whether it should authorize a utility to deviate from normal accounting rules?

A. Generally, the Commission in prior cases has stated that the standards for granting the authority to a utility to defer costs incurred outside of a test year as a regulatory asset, that the costs be associated with "extraordinary and nonrecurring" events. The Commission stated in *United Water Missouri, Inc.*, Case No. WA-98-187, pages 6-7:

> In order to justify the issuance of an Accounting Authority Order to permit the deferral of such costs, the costs incurred by the utility must result from an event or circumstances that is extraordinary, unusual and unique and not recurring.

I understand that the Commission rejected an AAO application in *Missouri Public Service Company*, Case Nos. EO-91-358 and EO-91-360. The Commission stated:

> Purchasing power or capacity to meet a company's demand for service is a fundamental undertaking of a regulated utility. A utility must plan for future demand and make a decision of how best to meet the demand. Purchase power capacity contracts which ensure a source of supply of energy for a period are a proper function of management. The fact that these contracts contain rate increases of additional charges as they mature does not render them extraordinary or unique. Costs of other services go up, while others may go down. If the Commission allowed deferral of these costs, then any expense with rising costs could arguably be deferred. As the Commission has discussed earlier, only costs associated with extraordinary, nonrecurring events should be deferred since they are not part of normal operating expenses of a company. Power purchases of this nature are not extraordinary events.
>
> The costs associated with the purchase power capacity contracts are recurring expenses. The Commission has established rates based upon both capacity costs and kW's purchased during the test year. The fact that these costs increase based upon the contract does not make them extraordinary. The fact that the contracts were entered into instead of building new peaking capacity does not make them extraordinary. The management of MPS is expected to make prudent and reasonable decisions to meets MPS's need for energy. This is a part of the normal operations of a utility and costs associated with these decisions are normal operating expenses which are recoverable through existing rates.

Q. Was the Commission's "extraordinary and nonrecurring" standard, as outlined in *Missouri Public Service Company*, Case Nos. EO-91-348 and EO-91-360, affirmed by the Western District Court of Appeals?

A. Yes, as I understand, the Western District Court of Appeals stated:

> [An AAO deferral]...distorts the balancing process utilized by the commission to establish just and reasonable rates. Because rates are set to recover continuing operating expenses plus a reasonable return on investment, only an extraordinary event should be permitted to adjust the balance..." *State ex. Rel. Missouri Office of the Public Counsel v. Public Service Commission*, 858 S.W. 2d 806 810 (Mo. App. 1993).

The Court of Appeals also noted that the USOA defines "extraordinary items" as:

> [t]hose items related to the effects of events and transactions which have occurred during the current period and which are not typical or customary business activities of the company...Accordingly, they will be events and transactions of significant effect which would not be expected to recur frequently and which would not be considered as recurring factors on any evaluation of the ordinary operating processes of business...*Id* at 810.

Q. Does Staff support MAWC's request for deferral of depreciation expense on Business Transformation assets in this case?

A. No. The business transformation is not an extraordinary event that the Company cannot plan to place in service and timely file for a rate increase to reduce regulatory lag. The Company controls the implementation of the assets; this is not like an "Act of God" in which the Company does not have any control. Also, the Company should incur some savings due to the implementation of the Business Transformation assets which should offset some of the costs of placing the assets into service. However, MAWC has not supported its request by performing any analysis of the net financial impact of deferring these costs versus not deferring these costs, taking into account savings related to the Business Transformation Program.

Q. Does one event which results in an expense or revenue change occur in a vacuum with respect to other possible changes in the operation of the utility?

A. No. The overall cost of service is made up of many factors, and isolating or focusing on the change of only one component, such as depreciation expense, fails to look at all relevant factors in determining the overall cost of service. Other factors may have changed that have a corresponding decrease or increase on the overall cost of service. Unless all factors are analyzed collectively, it is not appropriate to single out one specific event. If MAWC is unable to earn its authorized rate of return, then MAWC can file for a rate increase.

Q. From a regulatory accounting perspective, what occurs when an expense is deferred pursuant to an AAO?

A. From a regulatory accounting perspective, when a cost has been deferred it is not recognized on the income statement as an expense in the current period. The cost is recorded on the balance sheet in a section called Deferred Debits, pending the final disposition at some future point, usually a rate case. These deferred debit accounts act simply as a temporary holding site until the appropriate accounting ratemaking treatment can be determined.

Q. What is the practical effect of deferring costs with respect to how a company reports its earnings?

A. Under normal accounting practices, a utility would charge to expense on its income statement all incurred costs associated with an extraordinary event. If deferral of those costs is authorized, the utility treats the costs associated with an extraordinary event as a regulatory asset and records them on its balance sheet to be amortized over some period of time. In that manner, deferral authority allows the Company an opportunity to "manage" its reported earnings by ignoring costs incurred in a specific period that would have an impact on earnings (almost always negative). These costs are then included in the determination of earnings for several periods in the future and thus minimize the negative impact on reported earnings in one-year, as well as allow the utility an enhanced opportunity to recover the costs in rates.

Q. Should this management of earnings be a goal in ratemaking?

A. No, the goal of ratemaking should be setting just and reasonable rates and to give the Company an opportunity to earn a fair and reasonable return, not to guarantee any specific level of earnings or dollar for dollar recovery of every expense incurred by the Company.

Q. Is the deferral of a cost from one accounting period to another accounting period for the development of a revenue requirement consistent with traditional ratemaking practices?

A. No. Generally, the deferral of costs from one accounting period to another accounting period for the development of a revenue requirement violates the traditional method of setting utility rates. Rates in Missouri are usually established based upon a test period which focuses on four factors: (1) the rate of return the utility has an opportunity to earn; (2) the rate base upon which a return may be earned; (3) the depreciation expense related to plant and equipment; and (4) the allowable operating expenses including income and other taxes.

The relationship of the four factors is such that the expenses and rate base necessary to produce the revenues are synchronized. For example, the level of expense is developed based on the expected amount of sales that is used in the determination of revenue for the test period. Similarly, the plant in service necessary to produce or deliver water to customers is also based on the customers' usage for the same period. This process is often referred to as the "matching principle."

Deferral of expenses or costs from one period to another (and the amortization in subsequent periods) results in costs associated with the production of revenue in one period being charged against the revenue in different unrelated periods. This violates the "matching principle" and if unfettered would allow a utility to manage its earnings in order to avoid regulatory oversight or adverse reactions from the financial community. Avoiding this possibility is one of the fundamental purposes of Generally Accepted Accounting Principles (GAAP) and the Uniform System of Accounts (USOA).

Q. Why is the matching principle a cornerstone concern in the regulation of public utilities?

A. The litmus test in the regulation of public utilities is rate of return, the same as an equity investor in any publicly held company. GAAP and USOA rules provide a consistent basis for ensuring the revenues received in one period are properly offset with all costs incurred to provide those revenues so that a rate of return can be determined. This matching of revenues and costs to determine rate of return is fundamental to the regulatory process of setting rates and the subsequent review of adequacy of rates subsequent to a rate case. Similarly, investors can make decisions after reviewing financial statements (both historic and pro forma) and the resulting rate of returns developed using consistently applied rules that match revenues and costs.

Q. Has the Commission in the past allowed regulated utilities such MAWC to deviate from traditional ratemaking practices to defer costs from one accounting period to another accounting period via an accounting authority order?

A. Yes, as previously discussed, the Commission has determined that utilities, when warranted, can be allowed to defer costs from prior accounting periods on a limited basis when events occur during periods which are extraordinary, unusual and unique, and nonrecurring, through an AAO.

Q. Should the Commission merely consider the financial impact to a company when deciding whether to grant a deferral request?

A. No, if financial impact was the only consideration that would open a floodgate of opportunity for utilities to attempt to manage their earnings through the use of deferral accounting. An event such as an abnormally cool summer or warm winter would have significant impact on earnings. Other significant impacts could occur from any event in the normal course of utility operations that had a material impact on earnings. Other cyclical costs that are normalized for ratemaking treatment but are expenses on the utilities financial records include tree trimming expenses for electric utilities, tank painting for water utilities and overtime hours. However, these types of expenses are not appropriate subjects for deferrals; absent some evidence the cost was extraordinary, unusual and unique, and nonrecurring.

Q. What is regulatory lag?

A. Regulatory lag is a concept based on the difference in timing of a decision by company management and the Commission's recognition of that decision and its effect on the rate base/rate of return relationship in determination of a company's revenue requirement. Prudent management decisions that reduce the cost of service without changing revenues result in a change in the rate base/rate of return relationship. This change increases the profitability of the company in the short-term, and until such time when the Commission reestablishes rates that properly match the new level of service cost. Companies are allowed to retain cost savings, i.e., excess profits during the lag period between rate cases. When faced with escalating costs (expenses or investments) which will change the rate base/rate of return relationship adversely with respect to profits, regulatory lag places pressure on management to minimize the change in the relationship, by filing an application for a rate increase with the Commission.

Q. Is MAWC's request for special accounting treatment of costs related to Business Transformation assets designed to protect the Company against regulatory lag in entirety related to these assets?

A. Yes, by deferring the depreciation expense there will be no regulatory lag from the time the assets are placed in service to the time the Company's rates reflect the depreciation expense for these assets.

Q. Has the Commission ruled that it is not reasonable to protect shareholders from all regulatory lag?

A. Yes, in *Missouri Public Service Company*, Cases Nos. EO-91-348 and EO-91-360, the Commission stated:

> Lessening the effect of regulatory lag be deferring costs is beneficial to a company but not particularly beneficial to ratepayers. Companies do not propose to defer profits to subsequent rate cases to lessen the effects of regulatory lag, but insists it is a benefit to defer costs. Regulatory lag is a part of the regulatory process and a can be a benefit as well as a detriment. Lessening regulatory lag by deferring costs is not a reasonable goal unless the costs are associated with an extraordinary event.
>
> Maintaining the financial integrity of a utility is also a reasonable goal. The deferral of costs to maintain current financial integrity though is of questionable benefit. If a utility's financial integrity is threatened by high costs so that its

> ability to provide service is threatened, then it should seek interim rate relief. If maintain financial integrity means sustaining a specific return on equity, this is not the purpose of regulation. It is not reasonable to defer costs to insulate shareholders from any risk

Q. MAWC has also requested to continue accumulating allowance for funds used during construction (AFUDC) on Business Transformation assets until the assets are included in rates in the next rate case. Does Staff support this request?

A. No, Staff does not support this request, for the same reasons it opposed deferral of depreciation expense. The Company should continue following traditional ratemaking practices and stop accumulating AFUDC when the assets are placed in service.

Q. What is AFUDC?

A. AFUDC is the carrying cost incurred to finance a project during construction. Once the assets of a project are placed in-service the Company ceases accumulating AFUDC on the project and includes the accumulated AFUDC as a component of the capitalized cost of the project. The Company will then be allowed to earn a return on and of these funds.

Q. Is the Company's request to continue accruing AFUDC on Business Transformation assets also intended to protect it against the impact of regulatory lag?

A. Yes, in the sense that this treatment, if granted, would allow the Company to recover a "return" on the Business Transformation assets in the future to offset its alleged inability to earn a return in rates on these assets between the point that the assets are in service and when they are reflected in MAWC's rate base in a rate case proceeding.

Q. Has the Company also requested the Commission authorize a twelve year depreciable life for the Business Transformation assets?

A. Yes. Staff witness Arthur W. Rice of the Commission's Engineering and Management Services Department addresses Staff's opposition to MAWC's proposed twelve year depreciable life for Business Transformation assets in his rebuttal testimony filed in this case.

Q. Does this conclude your Rebuttal Testimony?

A. Yes.

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of Missouri-American Water Company's Request for Authority to Implement A General Rate Increase for Water and Sewer Service Provided in Missouri Service Areas	)))))	Case No. WR-2011-0337

AFFIDAVIT OF KIMBERLY K. BOLIN

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Kimberly K. Bolin, of lawful age, on her oath states: that she has participated in the preparation of the foregoing Rebuttal Testimony in question and answer form, consisting of 15 pages to be presented in the above case; that the answers in the foregoing Rebuttal Testimony were given by her; that she has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of her knowledge and belief.

Kimberly K. Bolin

Kimberly K. Bolin

Subscribed and sworn to before me this 19th day of January, 2012.

D. SUZIE MANKIN
Notary Public - Notary Seal
State of Missouri
Commissioned for Cole County
My Commission Expires: December 08, 2012
Commission Number: 08412071

D Suzie Mankin

Notary Public